

## DRW Investment Research

August 2011



### Beating the odds

Can today's large and successful investment funds repeat their performance record?

By Daniel R Wessels

If the probability of success is not almost one, then it is damn near zero.

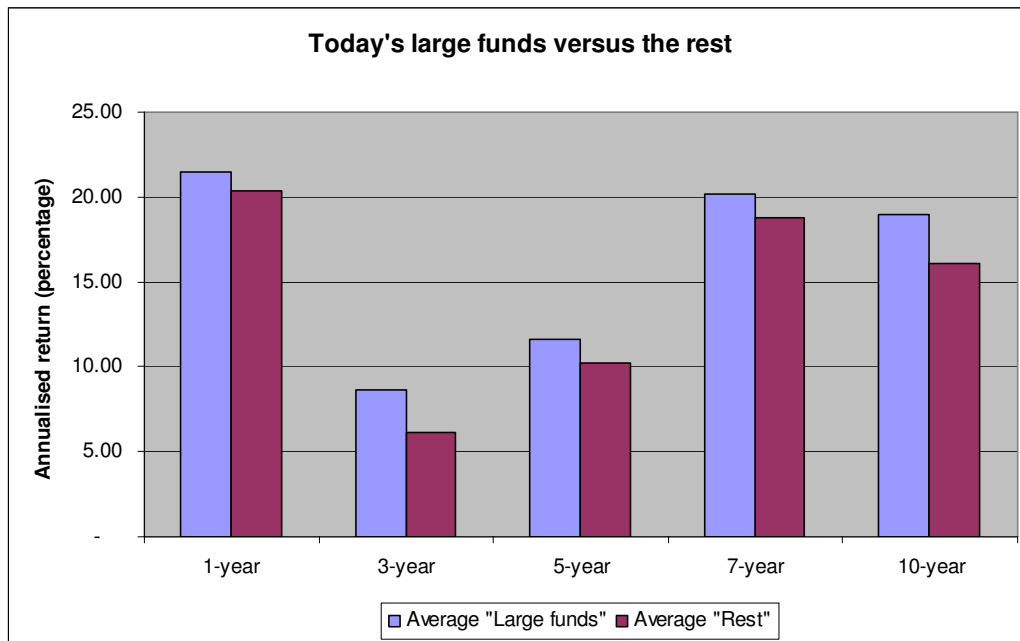
**David R. Ellis**

The 50-50-90 rule: Anytime you have a 50-50 chance of getting something right, there's a 90% probability you'll get it wrong.

**Andy Rooney**

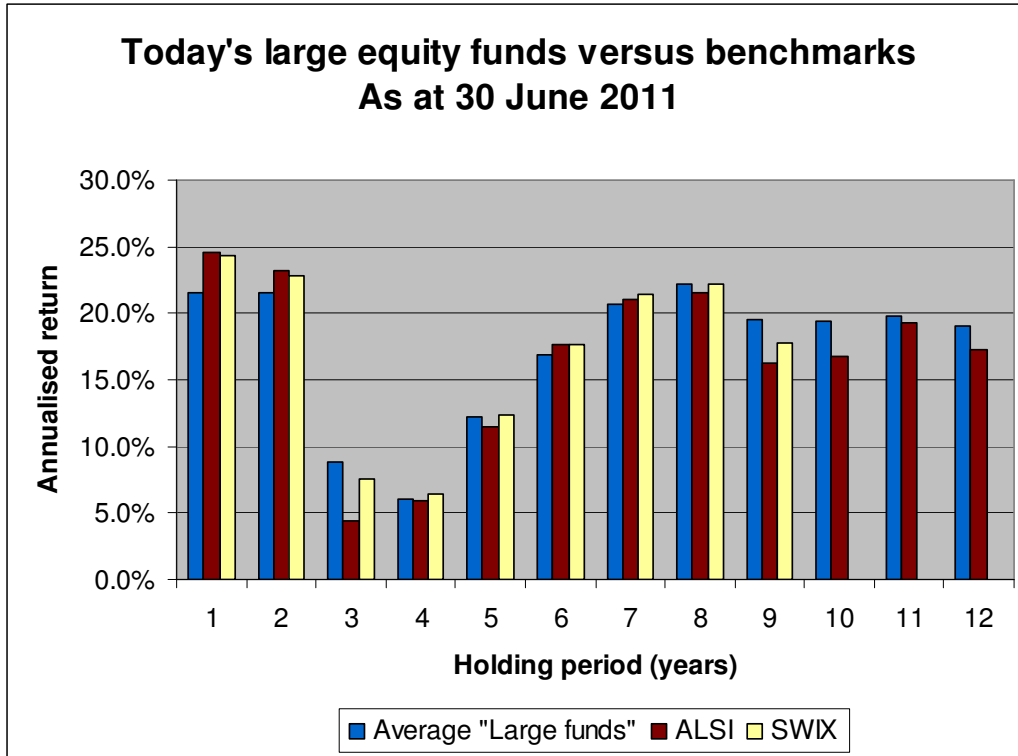
## 1. Today's Largest Equity Funds

- Typically these funds are the most well-known and popular funds among individual investors and advisors, or, if you like, the famous brands. As a group it constitutes 80% of all assets under management in the general equity, growth and value-style equity sectors of the collective investment industry (unit trusts).
- In total eleven fund management companies are represented in the top twenty largest equity funds. Among them are Allan Gray, Coronation, Investec, Old Mutual, Prudential, Sanlam (SIM) and Stanlib. While Nedgroup Investments is one of the biggest management companies it does not have its own fund management team and uses independent (often boutique) managers to manage specific investment mandates.
- All these funds have assets under management of more than R1.5bn (the biggest fund is Allan Gray with assets of more than R26bn). Many of these funds have outstanding long-term performance records (10-year plus).
- As a group today's large funds have outperformed the "rest" of equity fund managers, both over shorter term and long-term intervals, which obviously is a significant reason why these funds have attracted investors' funds over the past number of years.



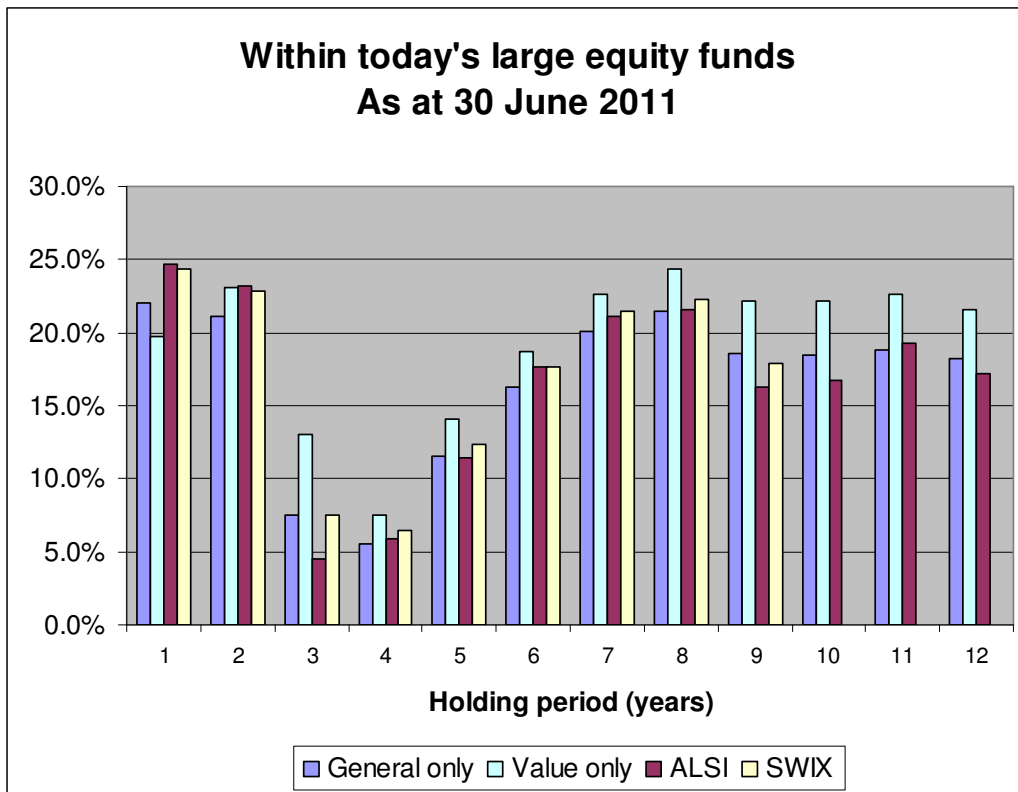
Source: DRW Investment Research

- These large funds, however, on average did not outperform the equity benchmarks (ALSI and SWIX) at least over the past eight years, but did so over the past nine to twelve years.



Source: DRW Investment Research

- Within today's large funds a clear pattern emerges which investment funds outperformed their peers and the market, namely a value-orientated style of investing. Such an evaluation, however, does not vindicate the notion that value investing will always be effective. For example, during the 1990s value investing did not fare very well and it was rather funds that concentrated on companies with high expected earnings growth that dominated investors' preferences.



Source: DRW Investment Research

## Fund ranking (relative to peers)

Fund	3-year	5-year	7-year	9-year
Allan Gray Equity A	Top	Top	Top	Middle
Community Growth Equity	Middle	Middle	Middle	Middle
Coronation Equity R	Top	Top	Top	Top
Investec Equity R	Bottom	Middle	Middle	Middle
Nedgroup Inv Rainmaker A	Top	Top	Top	Top
Oasis Crescent Equity	Bottom	Middle	Middle	Middle
Old Mutual Growth R	Top	Top	Top	Middle
Old Mutual High Yield Opp A	Top	Top	Middle	Middle
Old Mutual Investors R	Top	Top	Top	Middle
Prudential Equity A	Top	Top	Top	Top
RMB Equity R	Middle	Middle	Middle	Middle
Sanlam General Equity R	Top	Top	Top	Middle
STANLIB Equity R	Bottom	Bottom	Bottom	Bottom
STANLIB MM Equity FF A1	Middle	Bottom	Bottom	Middle
STANLIB Prosperity R	Bottom	Bottom	Bottom	Middle
Investec Value R	Top	Top	Top	Top
Nedgroup Inv Value R	Top	Top	Top	Top
Prudential Dividend Maximiser A	Top	Top	Top	Top
Sanlam Value R	Top	Top	Top	Top
STANLIB Value A	Middle	Top	Top	Middle
ALSI	Middle	Top	Top	Middle
SWIX	Top	Top	Top	Middle

Source: DRW Investment Research

*Top = top 20% of fund performances*

*Middle = between lowest and highest 20% of fund performances*

*Bottom = lowest 20% of fund performances*

## Beating the benchmark (SWIX)

Fund	3-year	5-year	7-year	9-year
Allan Gray Equity A	Above	Below	Above	Above
Community Growth Equity	Below	Below	Below	Below
Coronation Equity R	Above	Above	Above	Above
Investec Equity R	Below	Below	Below	Above
Nedgroup Inv Rainmaker A	Above	Below	Below	Above
Oasis Crescent Equity	Below	Below	Below	Below
Old Mutual Growth R	Above	Above	Below	Above
Old Mutual High Yield Opp A	Above	Below	Below	Above
Old Mutual Investors R	Below	Below	Below	Above
Prudential Equity A	Above	Above	Above	Above
RMB Equity R	Below	Below	Below	Above
Sanlam General Equity R	Above	Above	Above	Above
STANLIB Equity R	Below	Below	Below	Below
STANLIB MM Equity FF A1	Below	Below	Below	Below
STANLIB Prosperity R	Below	Below	Below	Below
Investec Value R	Above	Above	Above	Above
Nedgroup Inv Value R	Above	Above	Above	Above
Prudential Dividend Maximiser A	Above	Above	Above	Above
Sanlam Value R	Above	Above	Above	Above
STANLIB Value A	Below	Above	Below	Above

Source: DRW Investment Research

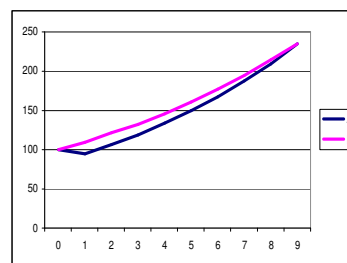
## 2. Performance Measurement 101

- How does one decide one fund/strategy is better than the other? Unlike a sports event or perhaps the evaluation of a project manager, investing does not necessarily have a definite entry (starting) and exit (end) points, but it is rather a continuous evaluation process. In fact, two individuals may have two very different experiences from the same type of investment. Thus one should be aware that the outcome of any evaluation is not a final validation that one fund/strategy is always better than the other.
- For example, consider two funds – A and B – that over a nine-year period yielded the same returns. An investor in fund A, however, experienced in the first year a negative return of 5% and thereafter yielded a positive return of 12% every year. Fund B yielded every year a positive 10% return. Which fund is the better? Well, it depends – An investor that in year one invested in fund B will be very happy with her fund performance and in fact be relieved that she did not invest in fund A. Another investor that invested in fund A from year two onwards will have no doubt that fund A is the better choice. Thus the starting point in any investment evaluation is often of paramount importance.

## Performance Measurement

- A good starting (reference) point is the key...

Period	Fund A	Fund B
1	-5%	10%
2	12%	10%
3	12%	10%
4	12%	10%
5	12%	10%
6	12%	10%
7	12%	10%
8	12%	10%
9	12%	10%
Annualised	10%	10%



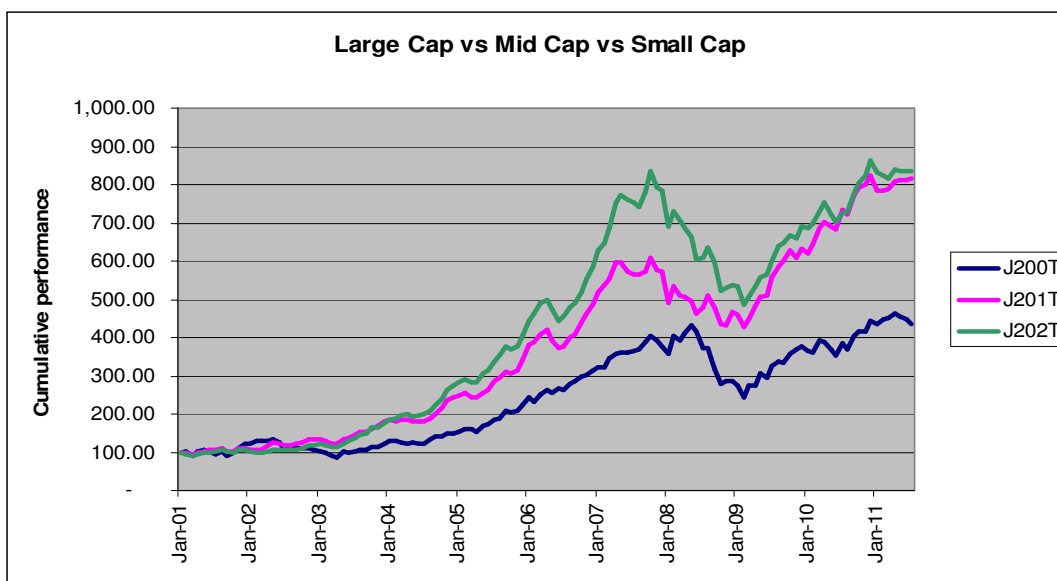
Which fund is the better?

- Likewise, the relative performance of a fund will be largely determined by its exposure to different sectors of the equity market (resources, financials and industrial stocks) at specific points in time. From time to time one of these equity sectors will yield vastly different returns from the others and the correct positioning of a fund during those times will give it a great head start relative to its peers or market benchmarks.

**Annual sector performances (resources, financials and industrials)**

Sector	Jun-11	Jun-10	Jun-09	Jun-08	Jun-07	Jun-06	Jun-05	Jun-04	Jun-03
RESI	20.6%	16.7%	-43.9%	39.9%	29.4%	84.2%	40.3%	9.4%	-25.0%
FINI	16.9%	22.2%	3.1%	-27.4%	30.7%	36.4%	46.9%	25.6%	-7.4%
INDI	34.9%	24.8%	-7.3%	0.0%	45.9%	34.1%	45.1%	44.7%	-25.3%

- An alternative way of explaining fund return differences will be allocations to small and medium-sized capitalisation stocks relatively to large cap stocks. While the former type of stocks is certainly less liquid and attracts less media and investors' attention than large cap stocks, it arguably represents more mispricing opportunities that an astute manager can exploit from time to time.



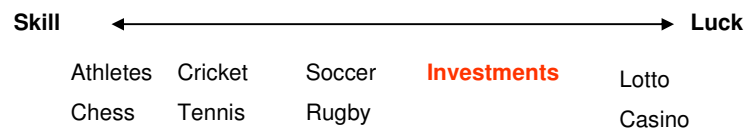
### 3. Luck or Skill: An Age-old Debate

- How do we know that the performance of a successful fund could undoubtedly be ascribed to manager's skill and perhaps not Lady Luck that smiled kindly upon the manager? Moreover, it is likely that both sides of the debate will find some evidence to back their arguments. Investment outcomes are probabilistic in nature and even if a manager has a good investment process in place it is no guarantee that performance will necessarily follow or reward such processes.
- Any probabilistic event is a combination of luck and skill. The type of activity or event determines to what extent skill (or luck) is the differentiating factor between success and failure. For example, a master chess player probably will always beat lesser skilled players or the fastest sprinter will always win the 100m race. In other sports, for example, soccer or rugby, a lesser skilled team may sometimes upset perceived better skilled teams – clearly luck (bounce of the ball, referee decisions!) plays a larger role in the outcome of such games. At the other extreme of the scale the game of roulette demands clearly no skill. Investing is probably tilted more towards luck than skill, however difficult it may be to accept for some.
- We need to recognise a number of factors that explain perhaps the dominant role of luck in investing. First of all, in fiercely competitive industries skill ultimately converges – lesser skilled opponents are becoming better all the time and catch up with the leaders. Thus luck will become the deciding factor if more or less the same skill set is competing for the honours. Secondly, social influences sometimes play havoc with the outcome of events. You and I may like something because it seems many others are favouring it too although objectively it may not be the best option. It means that real skill is not always duly rewarded by the market – for example, technically the best singers and writers are not selling the most songs and books. In investing it may well be that the most skilled managers do not attract the most monies in the fund management industry.



- Importantly, if luck prevails in any outcome one can expect some reversion to the mean. In investing we know no asset class is always performing better than the others. Or that a company will continue forever to grow its earnings at a rapid pace. Likewise, no fund manager will always outperform its peers.

## Luck or Skill?



- Reversion to the mean = the more luck is involved, the faster it will take place...
- Fierce competition = skill converges, luck plays bigger role...
- Social influences = skill not always fairly rewarded...
- Process = improving your process, improving your chances of success...
- Ultimate test for skill: Can you construct on purpose a portfolio of losers?

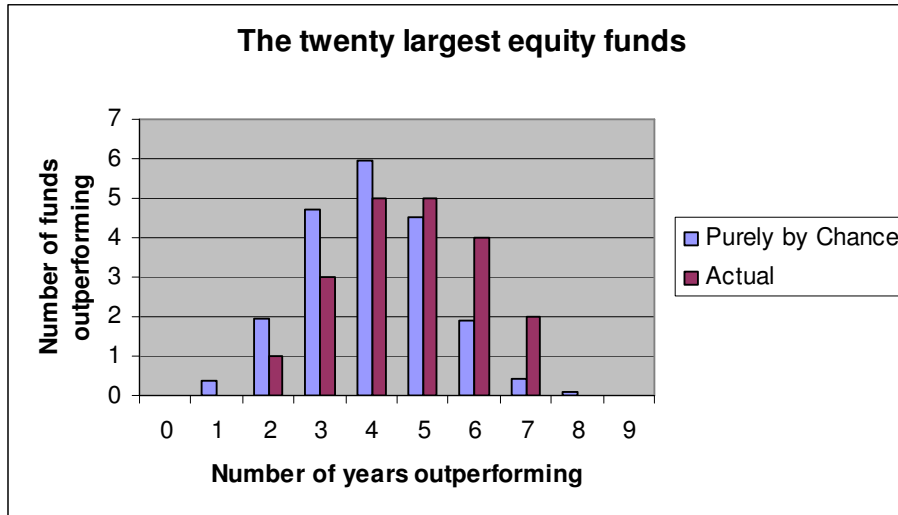
[Michael Mauboussin]

- One method of measuring managers' skill is to evaluate the number of periods a manager outperformed his benchmark within a specific time frame. For example, over the past nine years one would have expected that, based purely on chance, six of the largest twenty funds would outperform the market benchmark four times, two funds would outperform the market six times, etcetera. <sup>1</sup>

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<sup>1</sup> The statistical probability each year is calculated by the percentage of funds in the equity sector that outperform the market each year over the past nine years (June 2002 – June 2011).

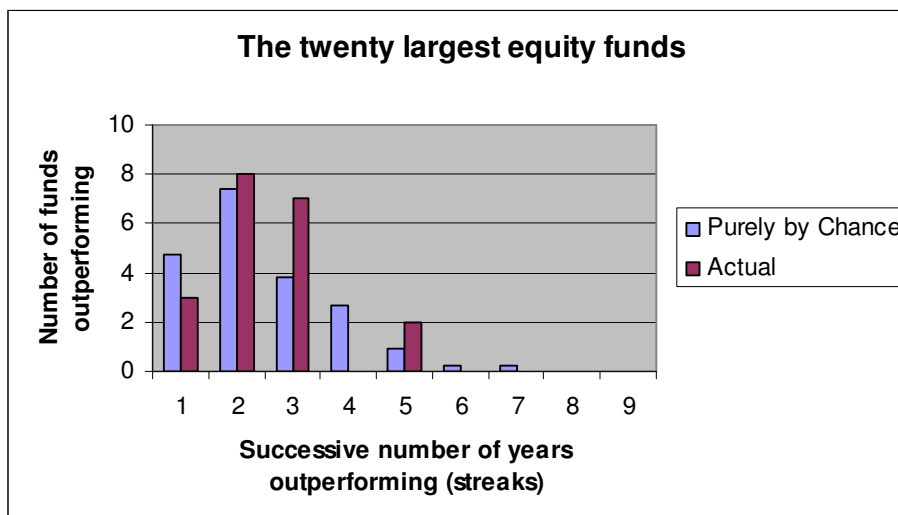
- We found, however, that more funds actually outperformed the market more times than can be explained by chance or luck only. For example, four funds outperformed the market six times and two funds did so seven times over the past nine years.



Source: DRW Investment Research

- Another indication of managers' skill will be to count the successive number of years (streaks) a fund outperformed the market benchmark and then compare it with the statistical probability distribution that it could happen by chance only.<sup>2</sup>
- Out of today's twenty largest funds we found seven funds that outperformed the market three years in a row as opposed to four funds that purely by chance would have accomplished the feat. Likewise, two funds outperformed the market for five years in a row while the statistical distribution predicted that one out of twenty funds would have achieved such a performance.

<sup>2</sup> For example, if a fund has a 40% probability of outperforming the market each year, then the probability that the fund will outperform the market for five successive years is given by  $(40\%)^5$  or basically 1% (1 in 100).



Source: DRW Investment Research

**Outperformance of the market (Jun 2002 – Jun 2011)**

Fund	Number of years	Successive years
Allan Gray Equity A	5	2
Community Growth Equity	3	2
Coronation Equity R	7	3
Investec Equity R	4	3
Nedgroup Inv Rainmaker A	5	3
Oasis Crescent Equity	4	2
Old Mutual Growth R	5	3
Old Mutual High Yield Opp A	5	2
Old Mutual Investors R	4	2
Prudential Equity A	7	5
RMB Equity R	4	3
Sanlam General Equity R	5	2
STANLIB Equity R	3	1
STANLIB MM Equity FF A1	2	1
STANLIB Prosperity R	3	1
Investec Value R	6	3
Nedgroup Inv Value R	6	2
Prudential Dividend Maximiser A	6	5
Sanlam Value R	6	3
STANLIB Value A	4	2

Source: DRW Investment Research

- Despite the aforementioned analyses it is by no means a foregone conclusion that a manager who has shown up as skilful will be regarded as such by investors, since they are more interested in the magnitude of outperformance. For example, a manager may outperform the market only once in, say, five years, but the magnitude of outperformance during that year is such that the manager's performance over the five-year period is still above average. Likewise, a manager that outperformed the market for, say, three years over the same period may still end up below average over the five-year period due to a single year of significant underperformance!
- Irrespective of the difficulties in measuring managers' skill beyond any reasonable doubt it is safe to say that a manager needs both skill and luck to stand out above the rest of the pack. Moreover, better investors have better probabilities of beating the market – akin to golf legend Gary Player's remarks: "The more I practice, the luckier I get".

#### **4. Will Today's Most Successful Funds Continue Their Winning Streak?**

- Let us review the major stumbling blocks that may prevent today's most successful and largest funds to repeat their performances of the past decade, which include fund size, the relatively low probabilities of outperformance and erratic investor behaviour.
- What does history tell us about the likelihood that fund performances of the largest funds can be repeated over another longer term cycle? For example, the top-performing funds over the past ten years were mostly value-style equity funds, but they were relatively small funds ten years ago. The exceptions are three large funds which also ten years ago were among the largest funds. Over the past five years, however, only one historically large fund was among the top performers. Thus there is perhaps not ample evidence that large funds will be again at the forefront of fund performances over another long-term period.

Top ten equity fund performances over the past ten years (Jun 2001 – Jun 2011)

Fund	Jun-01	Fund size (Jun 2001)
	Jun-11	Relative Rank
Investec Value	26.03	< 50th percentile
Nedgroup Inv Value	23.02	<40th percentile
RMB value	22.23	<40th percentile
Nedgroup Inv Rainmaker	22.16	<100th percentile
SIM Value	21.64	<40th percentile
Allan Gray Equity A	20.74	<100th percentile
Prudential Equity	20.04	<40th percentile
Old Mutual High Yield Opp A	20.01	<50th percentile
Investec Equity	19.54	<100th percentile
Prudential Dividend Maximiser A	19.46	<40th percentile

Source: DRW Investment Research

Top ten equity fund performances over the past five years (Jun 2006 – Jun 2011)

Fund	Jun-06	Fund size (Jun 2006)
	Jun-11	Relative Rank
ABSA Select	15.62	<20th percentile
Kagiso Equity Alpha	14.88	<10th percentile
Nedgroup Value	14.83	<50th percentile
Coronation Equity	14.71	<90th percentile
Prudential Equity	14.41	<40th percentile
SIM Value	14.39	<70th percentile
Prudential Dividend Maximiser A	13.93	<40th percentile
SIM General Equity	13.85	<60th percentile
RMB Value	13.75	<50th percentile
Marriott Dividend Growth	13.39	<60th percentile

Source: DRW Investment Research

- Investors often are too optimistic (or misinformed) of the real probabilities that a specific fund will continue to deliver market-beating returns. It is in fact very difficult to beat the market in which both skill and luck are prerequisites for success. If one scrutinises merely today's fund performances and comparisons it does not reflect the performance data of funds that ceased to exist and thereby it masks the real experiences of investors in the past (known as survivorship bias). For example, today it may seem that more than half of all equity funds outperformed the market over the past ten years, but when accounting for survivorship bias the real success rate is down to 30% of all possible funds. Over a twenty-year period fewer than 20% of all funds have outperformed the market.

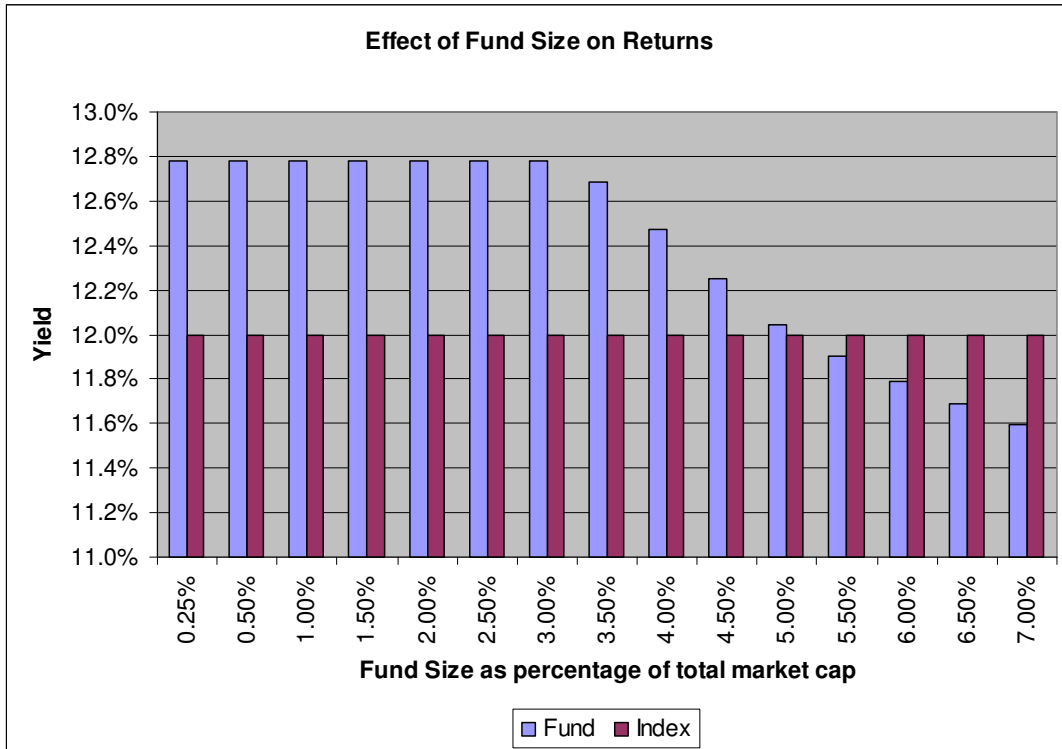
**Outperforming the market: Less likely than it may seem**

	10-years	15-years	20-years
All Share Index	16.7%	14.7%	15.1%
Top surviving funds	26.0%	17.3%	18.0%
Worst surviving fund	11.7%	10.5%	13.0%
Average surviving fund	16.9%	13.1%	14.2%
Number of funds outperforming	27	3	3
Total number of surviving funds	49	18	8
"Reported" success ratio	55%	17%	38%
Total funds available at the time	86	25	17
"Real" success ratio	31%	12%	18%

Source: Nedgroup investments

- Success breeds success. In fund management terms it means more inflows of monies as investors want to share in the "magic touch" of the fund manager. More inflows of monies mean more assets under management on which the manager will charge fees. More inflows also mean that the manager must allocate more monies to larger cap stocks as fund constraints and rules prohibit oversized exposures to small and mid cap stocks. These fund rules, together with continuous fund inflows, may

result in a portfolio positioning that is not necessarily preferred by the manager. In fact, at a certain fund size the portfolio will not be materially different from the market index, but because of management fees the fund is basically guaranteed to underperform the benchmark. Thus, while fund popularity is great for the fund management business, it is not necessarily equally beneficial for the investor.

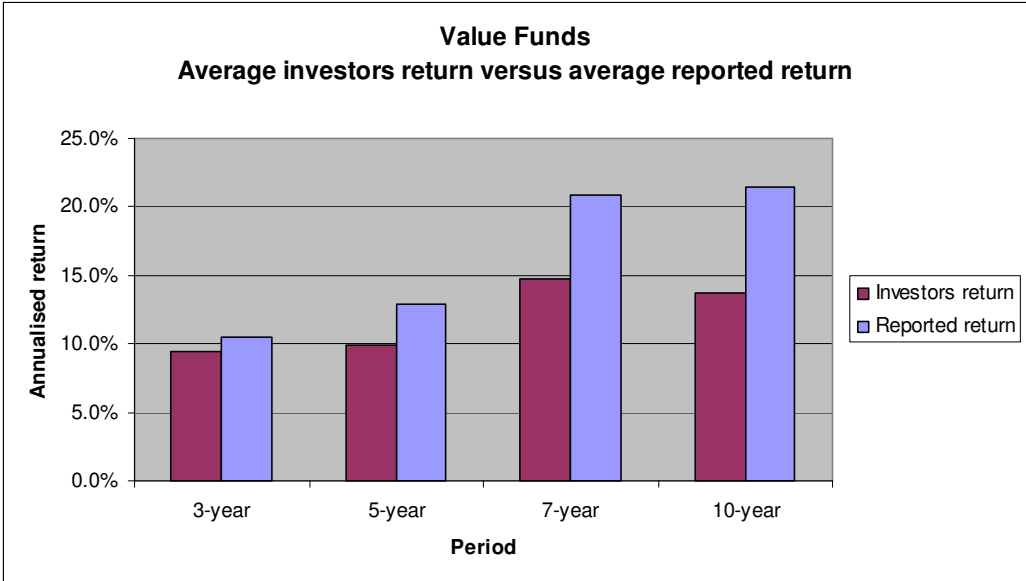


Source: DRW Investment Research

- Only a few things are certain with investments. One of them is that investors will flock to well-performing funds. This type of behaviour causes regular switching of investment funds to the latest hot performers as if the relative outperformance of a manager will continue forever. Investors may falsely believe that a fund's performance over a certain time period is equal to what she earned on her investment. That is not likely to be true since she could have made additional investments or withdrawals during the investment term. Thus on the one hand is the fund or reported return that ignores specific cash flows to and from the fund and on the other hand the investor's return that accounts for specific inflows and outflows (investors' transactions). In the

latter case one should calculate the investor's internal rate of return as opposed to a time-weighted calculation.

- Value equity funds undoubtedly have been the best performing equity funds over the past decade. On average these funds yielded more than 20% return per annum, but when accounting for the actual cash flows to and from value funds, investors earned on average only about 13% per annum over the past ten years. A similar pattern repeats itself over other time intervals. For example, over the past seven years investors on average earned about 15% per annum against the average fund return of more than 20% per annum.



Source: DRW Investment Research



## 5. Sensible Investment Strategies

- Probably the worst strategy is to invest in a fund manager based purely on past performances, but without an appreciation and understanding of the manager's investment philosophy and process. It is safe to say that investors are bound to be disappointed with the relative performances of today's successful managers even if it is only for relatively short periods of time somewhere in the future.
- No particular style of investing (or manager) will be performing well all the time. An investor that is not acquainted with a manager's process is likely to consider switching to another fund that is perhaps performing above average at the time. But without the necessary understanding of a manager's investment processes and styles, the same poorly motivated reasons for switching are likely to be repeated over and over again. Chances are that such investors will end up with much less than they would have received from an ordinary buy-and-hold investment. Thus it may be better to make a concerted effort of understanding a manager's investment philosophy and process than simply studying performance tables.
- In this presentation we have seen that the likelihood of a large and successful fund remaining a top performer over the longer term somewhere in the future is not particularly high, or at least not necessarily better than others despite some evidence of skill. Nonetheless, some investors will find comfort in the knowledge that they are invested with a large, respected and trusted management firm, even if it means that their future returns will not be among the highest performers. For other investors it is a much more daunting task (guesswork) to predict the next set of winners.

- Luckily investors have an array of “alternative” investment options that mitigate the risk of betting all your monies on perhaps managers that will underperform relatively to other managers and the market, namely to invest in index or enhanced market index funds, such as ETFs (TOP40, SWIX, RAFI, DIVI, etcetera) which typically are up to 50% cheaper than actively-managed funds. Moreover, the performance of such investments is likely to yield above-average returns relatively to the performance of actively-managed funds.

*As always, in the next five to ten years we will praise the star performers and market-beaters. That much we know, but we do not know whether they will be again today's successful managers or perhaps today's lesser known managers.*



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